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In the Supreme Court of the United States

OCTOBER TERM, 1947

No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

LEWIS F. JACOBSON

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Seventh Circuit entered in the above-entitled cause on December 5, 1947.

OPINIONS BELOW

The opinion of the Tax Court (R. 120-135) is reported in 6 T. C. 1048. The opinion of the Circuit Court of Appeals (R. 166-174) is reported in 164 F. 2d 594.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 5, 1947. (R. 174-175.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer, who was solvent during the taxable years, realized income, within the meaning of the applicable tax statutes and regulations, when he purchased his own bonds at less than their face value.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:
* * * *

(3) *Gifts, bequests, and devises.*—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income);
* * *

Section 22 (a) and (b) (3) of the Internal Revenue Code (26 U. S. C. 22) is identical with the above provisions.

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 22 (a)-14. *Cancellation of indebtedness.*—(a) *In general.*—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See article 22 (a)-18.) * * *

Section 19.22 (a)-14 of Treasury Regulations 103, promulgated under the Internal Revenue Code, is identical with the above provisions.

STATEMENT

The facts as found by the Tax Court relating to the purchase by the taxpayer of his own bonds (R. 122-128) may be summarized as follows:

The taxpayer is an individual, residing in Chicago, Illinois, where he filed his income tax returns. (R. 122.) The taxable years are 1938, 1939 and 1940. (R. 121.)

In May 1925, the taxpayer borrowed \$90,000 from the South Side Trust and Savings Bank, and he and his wife executed 200 bonds secured by a mortgage trust deed on certain real estate

in Illinois to evidence the loan? The proceeds of the loan were used to pay off the existing encumbrance on the property; to pay for an addition to the building which cost \$16,250, and to pay the necessary brokerage commissions and expenses in connection with the loan, leaving a small surplus over and above these items which was paid to the taxpayer. (R. 122-123.)

The bonds were payable at the rate of \$2,500 semiannually to and including November 1, 1931, and the balance of \$57,500 on May 1, 1932, with interest at $6\frac{1}{2}\%$ per annum. All of the bonds which became due up to and including November 1, 1931, were paid at or about their respective maturity dates. On June 8, 1931, the South Side Trust and Savings Bank failed to open its doors. (R. 123.)

A bondholders' committee was formed for the bondholders who had purchased bonds on the taxpayer's building. On May 1, 1932, the taxpayer applied to the bondholders' committee and the bondholders themselves for an extension of time for the payment of this loan; and procured an extension to May 1, 1937, for the payment of the principal of the bonds. At no time did the taxpayer default in the payment of interest on the bonds. During this extended period checks for interest were issued by the taxpayer directly to the holders of the bonds and were delivered to them by the secretary of the committee. (R. 123.)

In 1937 the taxpayer again procured an extension of time for the payment of the bonds to 1942, and in that connection paid 10% on account of the principal of the bonds, leaving an unpaid balance as of January 1, 1938, of \$51,750. (R. 123.)

In 1938, 1939, and 1940, the taxpayer purchased certain of his bonds for amounts less than their face value. Some of the purchases were directly from the holders, and some were through brokerage firms or through the bondholders' committee. (R. 123-126).¹ There was never any listing of the

¹The following table shows the dates of purchase, method of purchase, face value and purchase price of the taxpayer's bonds which he bought during the taxable years:

Date of purchase	D—Direct, B—broker, C—Bondholders' committee	Face value	Purchase price	Percentage of face amount paid by taxpayer
<i>1938</i>				
Apr. 9, 1938 (R. 123-124)	D	\$450	\$202.50	45
June 9, 1938 (R. 124)	B	3,600	1,620.00	45
Aug. 17, 1938 (R. 124)	D	900	405.00	45
1938	D	900	957.00	+100
<i>1939</i>				
Feb. 15, 1939 (R. 124)	B	1,800	900.00	50
June 16, 1939 (R. 124)	B	450	225.00	50
Oct. 23, 1939 (R. 124)	B	180	86.50	48
<i>1940</i>				
Apr. 4, 1940 (R. 125)	C	270	130.00	48
May 21, 1940 (R. 125)	C	450	210.00	47
May 23, 1940 (R. 125)	C	2,700	1,080.00	40
June 19, 1940 (R. 125)	C	1,800	720.00	40
July 1, 1940 (R. 125)	B	450	218.50	41
July 3, 1940 (R. 125)	B	450	175.00	39
July 10, 1940 (R. 125)	B	450	181.50	41
Sept. 23, 1940 (R. 125)	B	450	185.00	41
Total		17,900	7,265.50	

¹ Approximate figure.

bonds or a quoted price. Nobody was buying these bonds except the taxpayer. (R. 126.)

At all times during the years 1938, 1939, and 1940, the value of the property securing the bonds exceeded the bonded indebtedness. (R. 126.) The taxpayer owned considerable other property in Chicago outside of the property which secured the bonds (R. 127), and had gross income from other sources in excess of \$35,000 in each of those years (R. 126). The taxpayer was solvent during each of the taxable years 1938, 1939 and 1940. (R. 127.)

The Tax Court distinguished between the bonds purchased directly from the holders and the bonds purchased through brokers and the bondholders' committee. With respect to the bonds purchased through brokers and the bondholders' committee, the Tax Court held that the difference between the issuance price and the purchase price constituted taxable income under *United States v. Kirby Lumber Co.*, 284 U. S. 1. With respect to the bonds purchased through direct negotiations with the bondholders, it held that the difference between the purchase price and the issuance price represented gifts under *Helvering v. Amer. Dental Co.*, 318 U. S. 322. Five of the six dissenting judges of the Tax Court expressed the view that the *Kirby Lumber* case governed all the transactions here in question. (R. 132-135.) On cross-appeals to the court below, it was held that the *American Dental* case governed all of the

transactions and hence that no income was realized by the taxpayer from any of the purchases. (R. 171.)

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In deciding that where the taxpayer purchased his own bonds at less than their face value, the taxpayer did not realize income within the meaning of Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code and the applicable Treasury Regulations.

2. In failing to decide that where the taxpayer purchased his own bonds at less than their face value, he realized income within the meaning of Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code and the applicable Treasury Regulations, regardless of whether he purchased them by direct negotiations with the holders or through a broker or other intermediary.

3. In reversing that part of the decision of the Tax Court which held that where the taxpayer purchased his own bonds at less than their face value through a broker or other intermediary, he realized income within the meaning of Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code and the applicable Treasury Regulations.

REASONS FOR GRANTING THE WRIT

1. The decisions of the Tax Court and of the court below in this case reflect a general confusion

that exists in regard to the proper interpretation of two decisions of this Court, *United States v. Kirby Lumber Co.*, 284 U. S. 1, and *Helvering v. Amer. Dental Co.*, 318 U. S. 322, with particular reference to the extent to which the later case impliedly qualified or limited the principle expressed in the *Kirby Lumber* case. In the latter case this Court held that where a corporate taxpayer purchased its own bonds at a discount, the difference between the purchase price and the face value constituted income. This conclusion was supported on two grounds: (1) the Treasury regulations so provided, and they should not be rejected as an erroneous statement of the law; and (2) the transaction made available to the taxpayer assets previously offset by the obligation of bonds now extinct. In the *American Dental* case, this Court held that the forgiveness of back rent and the cancellation of interest on notes did not constitute income to the debtor, but represented a gift within the meaning of Section 22 (b) (3) of the Rev. Act of 1936, c. 690, 49 Stat. 1648, regardless of donative intent on the part of the creditor. The *Kirby Lumber* case was neither overruled nor qualified in any way.

The inability of the Tax Court and the lower courts to effect a satisfactory reconciliation of these decisions is graphically evidenced by the three different rulings made by the various judges who considered this case below: (1) The *American Dental* case controls all of the transactions in which the taxpayer purchased his

own bonds for less than their face value, as held by the court below. (2) The *Kirby Lumber* case controls all of the transactions, as held by the dissenting judges of the Tax Court. (3) Some of the transactions are controlled by the *American Dental* case and others by the *Kirby Lumber* case, depending upon whether the taxpayer had direct negotiations with the bondholders, as held by the majority of the Tax Court.

2. Other courts have reached results that indicate conflicting interpretations of the *American Dental* case, as applied to the purchase of bonds or other evidence of indebtedness at less than face value.² A number of law review articles and one of the leading text books on federal income taxation refer to the difficulty of reconciling the *American Dental* case with the *Kirby Lumber* rule.

The decision of the court below appears to be in conflict with the decision of the Circuit Court of

² *Shellbarger Grain Products Co. v. Commissioner*, 146 F. 2d 177, 187 (C. C. A. 5th); *A. M. Canpau Realty Co. v. United States*, 69 F. Supp. 133 (C. Cls.); *Central Paper Co. v. Commissioner*, 158 F. 2d 131 (C. C. A. 6th); *Fifth Ave. Fourteenth St. Corp. v. Commissioner*, 147 F. 2d 453 (C. C. A. 2d).

³ Plumb, *The Tax Benefit Rule Today*, 57 Harv. L. Rev. 129, 141, fn. 53 (1943); Lynch, *Some Tax Effects of Cancellation of Indebtedness*, 33 Fordham L. Rev. 145, 157-168 (1944); Eisenstein, *Some Iconoclastic Reflections on Tax Administration*, 58 Harv. L. Rev. 477, 516 (1945); 12 Fordham L. Rev. 198 (1943); 11 Geo. Wash. L. Rev. 537 (1943); 44 Columbia L. Rev. 102 (1944); 2 Mertens, *Law of Federal Income Taxation*, 1947 Cumulative Pocket Supp., Sec. 11.19, pp. 37-38.

Appeals for the Sixth Circuit in *Central Paper Co. v. Commissioner*, 158 F. 2d 131 and with the decision of the Circuit Court of Appeals for the Second Circuit in *Fifth Ave.-Fourteenth St. Corp. v. Com.*, 147 F. 2d 453. In the *Central Paper Co.* case, the taxpayer purchased from the certificate holders, at prices below par, trustee's certificates, which had been issued in lieu of outstanding bonds of its predecessor, liability for which was assumed by the taxpayer. The Commissioner determined that the difference between the purchase price and the face value constituted income under the rule of the *Kirby Lumber* case. Both the Tax Court and the Sixth Circuit upheld the Commissioner. The latter court distinguished the *American Dental* case on the ground that the certificate holder had made a bona fide sale in the open market due to the latter's preference to receive cash immediately in a reduced amount rather than to receive preferred stock or to wait for the liquidation of the trust. Since the taxpayer bought the certificates from the holder, the result seems to be in conflict with the decision of the court below. The intervention of the trustee between the taxpayer and the certificate holder would seem to be unimportant because the trustee played no substantial part in the transaction.

In the *Fifth Ave.-Fourteenth St.* case, the taxpayer purchased mortgage certificates issued by taxpayer's mortgagee, for less than their face value and the mortgagee accepted the certificates at face

value in reduction of the taxpayer's indebtedness. The Commissioner determined that the amounts by which the face value of the certificates exceeded the taxpayer's cost constituted taxable income under the *Kirby Lumber* rule. Both the Tax Court and the Circuit Court of Appeals upheld the Commissioner; however, the latter court made its conclusion depend upon the solvency of the taxpayer, and remanded the case to the Tax Court to determine whether the taxpayer was solvent during the taxable years. Since the taxpayer was solvent in the present case, the decision of the court below appears also to be in conflict with the decision of the Second Circuit in the *Fifth Ave.-Fourteenth St.* case.

3. The decision of the court below appears to be wrong because the facts of this case resemble those of the *Kirby Lumber* case more closely than those of the *American Dental* case. In the *Kirby Lumber* case a corporation purchased its own bonds at a discount; in the present case an individual purchased his own bonds at a discount. If the corporation in the *Kirby Lumber* case realized income as this Court held, it follows that the individual in this case also realized income. The Treasury Regulations indicate that an individual, as well as a corporation, realizes income under such circumstances. See Treasury Regulations 101, Art. 22 (a)-14, and Treasury Regulations 103, Sec. 19.22 (a)-14, *supra*. The taxpayer was solvent during the taxable years (R. 127) and

by virtue of his purchase of his own bonds at a discount, his net assets were increased just as the corporate taxpayer's net assets were increased by similar transactions in the *Kirby Lumber* case.

The court below took the view that the only distinction between the *American Dental* case and the *Kirby Lumber* case is that in the former the purchases were not made "in the open market" (R. 169-170,) while in the latter they were so made. But we do not believe that the distinction made by the court below is valid. In this Court's opinion in the *American Dental* case, reference is apparently made (p. 330) to the transactions in the *Kirby Lumber* case as "arm's-length". If "arm's-length" is the correct test, the transactions in this case would come within the *Kirby Lumber* rule because there is no evidence in the record to show that both parties were not trying to make the best possible bargain. The transactions in this case were not deals between insiders; rather were they deals in which the taxpayer unquestionably bargained at "arm's-length" with the bondholders. One bondholder got more than 100 cents on the dollar (R. 124), and the holders of about 70% of the principal amount of outstanding bonds refused to sell their bonds to the taxpayer (see fn. 1, *supra*, p. 5, and compare with \$51,750 face value of bonds outstanding, R. 123).

4. In several instances Congress has exempted from tax income attributable to the discharge of

indebtedness.⁴ Where it has done so, it has required certain adjustments in regard to basis in order clearly to reflect income. In the absence of an express statutory exemption none should be implied. *Bank of Commerce v. Tennessee*, 161 U. S. 134, 146; *Hale v. State Board*, 302 U. S. 95, 103; *Pacific Co. v. Johnson*, 285 U. S. 480, 491; *United States v. Stewart*, 311 U. S. 60, 71.

The holding of the court below that the difference between the face value and the price paid by the taxpayer for his bonds constitutes a gift within the meaning of Section 22 (b) (3) of the Internal Revenue Code, *supra*, because the bondholders knew that the taxpayer was buying the bonds, is untenable. The mere fact the seller deals directly with the purchaser or his agent does not support the conclusion that the seller did not attempt to get as high a price as possible or that the transaction was not at arm's-length. There is no evidence in the record to show that the bondholders did not seek to get the highest possible price from the taxpayer, which of course precludes the possibility of a gift. Therefore there is no factual basis in this case for a holding that the bondholders made gifts to the taxpayer of the

⁴ Internal Revenue Code, Sec. 22 (b) (9) and (10), as added by Sec. 215 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862, and Sec. 114 (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, respectively (26 U. S. C. 22); Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 544, Secs. 68-70, as amended by the Chandler Act of June 22, 1938, c. 575, 52 Stat. 849, Sec. 1, and by the Act of July 1, 1940, c. 500, 54 Stat. 709, Sec. 1 (11 U. S. C. 668-670).

difference between the face amount of the bonds and the selling price.

5. The case is of general importance because the same question may arise in any case where a taxpayer has bonds outstanding. According to the decision of the court below, in every case where a debtor purchases his or its own bonds at a discount and the seller (bondholder) knows that the debtor is buying the bonds, the difference between the face value and the purchase price constitutes a gift and not income, regardless of any donative intent on the part of the bondholder. There are a number of cases involving the same question pending in the Tax Court and in the lower federal courts.⁵ In a decision rendered since that of the court below, the Tax Court has refused to follow the rule laid down by the court below on the ground that it would constitute an unwarranted extension of the *American Dental* rule.⁶

CONCLUSION

In order to resolve the conflict and confusion that generally prevail with regard to the proper scope of the *Kirby Lumber* and *American Dental* decisions, this petition for a writ of certiorari should be granted. The decision of the court below is wrong,

⁵*Edmont Hotel Co. v. Commissioner*, 10 T. C. No. 31, promulgated Feb. 10, 1948.

⁶The Bureau of Internal Revenue advises that there are over 40 similar cases in various stages of litigation or controversy, involving about \$3,000,000 in income taxes.

and the question involved is of general importance.

Respectfully submitted.

PHILIP B. PERLMAN,

Solicitor General.

MARCH 1948.